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No. 618

Supreme Court of the United States

OCTOBER TERM, 1949

CONTINENTAL OIL COMPANY, a Delaware Corporation,
Petitioner,

VERSUS

H. C. JONES, Collector of Internal Revenue,
Respondent.

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE TENTH CIRCUIT

REPLY BRIEF FOR THE PETITIONER

It may serve to narrow the limits of needful discussion to point out, first, that Respondent does not challenge the proposition that the Commissioner of Internal Revenue is and should be bound by all knowledge possessed by him with respect to a taxpayer's liabilities regardless of the source of such knowledge. This is the subject of the Second Reason for Allowance of the Writ and Second Assignment of Error in the Petition for Certiorari.

Conflict with Ross v. Commissioner, 169 Fed. 2d 483 (1 Cir. 1948)

It is conceded: "Petitioner may be correct in asserting (Pet. 10) that the decision below is in conflict with the *Ross* decision on the question whether the Commissioner

is bound by knowledge gained from sources other than the taxpayer's returns and records * * *." (Respondent's Brief 11). It is further stated: "The *Ross* decision held in effect that the Commissioner was bound by knowledge obtained from other sources * * *." (Respondent's Brief 12).

Perfect ingenuousness would have compelled omission of the words "in effect" from the clause last quoted, but the significance of the statement on the question of conflict is not lost by its having been too cautiously phrased.

Respondent argues, however, that the conflict with the *Ross* case "is not such as to justify the granting of the instant petition for writ of certiorari" (Respondent's Brief 11) because, says the Respondent, "the evidence of the Commissioner's knowledge was used *only* to support the conclusions that the Commissioner was justified in relying upon the taxpayer's returns for no more than the taxpayer's honest understanding of his liabilities and that it was the Commissioner's duty to make up his own mind as to taxability of accrued salaries." (Respondent's Brief 12). (Emphasis supplied). The use of evidence of knowledge, from whatever source, may not be thus limited. If found to be true, as in the case here, its use is to destroy completely the defense of estoppel.

The Court of Appeals in deciding the *Ross* case would not have bothered to reach the conclusions referred to if they had been but an end within themselves, having no bearing upon the ultimate issue, estoppel. Surely, in saying that the Commissioner was bound by whatever knowledge he had acquired, regardless of its source, and that knowing the facts he was bound to make his own decisions, the

Court was not merely instructing the Commissioner as to his duties. Those observations were but logical steps leading to the conclusion that in the state of the record there under review estoppel was not proved. The Court held: (1) The Commissioner is bound by facts known to him, no matter what the source of his information; (2) Where he knows the truth concerning an item of income, he cannot close his eyes to it and rely on a taxpayer's return which may contain misrepresentations or no information at all with respect to such item, and, having knowledge of the facts, it is his duty to make up his own mind as to the liabilities of the taxpayer; and (3) If he does not seasonably do so and follow his decision by appropriate action, he cannot avoid the statute of limitations by pleading estoppel.

Respondent argues now that the failure on the part of the taxpayer to return income was treated in the *Ross* case as a mistake of law. The Commissioner in that case contended just as vigorously as does the Respondent here that the mistake was one of fact—that the taxpayer had made a misstatement of fact (169 Fed. 2d 495). It is a fairer over-all appraisal of that opinion to say that the Court ruled out the estoppel defense whether the taxpayer's mistake be considered as one of fact or as one of law. The important thing was that the Commissioner knew that the income had not been reported for the years in which it was received, or at least he had failed to discharge the burden of proving that he had not learned of such fact from sources *aliunde* the return.

For the purpose of showing the effect of knowledge

on the part of the Commissioner on his plea of estoppel, the Court accepted the Commissioner's contention that the failure to return the shares amounted to a misrepresentation of fact, and referred to the circumstance that the Commissioner relied on *Crane* v. *Commissioner*, 68 Fed. 2d 640 (1 Cir. 1934). In that connection, the Court did not say that such a mistake is one of law rather than of fact, but pointed out that the *Crane* and *Countway** cases were not controlling because "knowledge of the *facts* not disclosed was not imputed to the Government" (Italics supplied).

Where knowledge of the truth is possessed by or imputed to a party pleading estoppel, it can make no difference on that issue whether the alleged misrepresentations are of fact or of law, or a mixture of both.

Indeed, questions of imputed knowledge and reliance on the opposite party's statements can arise in such cases only when the statements are factual, for, as the court said in the *Ross* case, "it seems settled that estoppel cannot be predicated upon a mere statement of law or silence resulting from an error of law" (p. 496).

It is evident that Respondent's confusion on the subject results from not distinguishing between the failure of the taxpayer in the *Ross* case to report the *fact* of receipt of income and his mistake of law which induced his failure to report that fact; and, likewise, his failure in the case at bar to distinguish between the fact of the return of the shares at $1.00 and the taxpayer's mistake of law which induced it to thus return the shares.

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*Countway v. Commissioner, 127 Fed. 2d 69 (1 Cir. 1942).

The Court's disposition of the estoppel contention in the *Ross* case assumed the possibility of misrepresentations of fact as well as of law, and, that, on remand, the tax court might or might not find that the Commissioner knew the facts from sources other than the taxpayer's returns and records. Two rules laid down covered every possible set of circumstances that might be found by the tax court. There could be no estoppel (1) in the absence of either deliberate or unintentional misrepresentation of facts (p. 496 2nd col.); or (2) if, notwithstanding the presence of such misrepresentation, the Commissioner knew the truth from other sources, or ought to have known the truth* (p. 495 2nd col.).

The taxpayer in the *Ross* case had failed to report income in the year received, apparently because he thought he was not required to return his salary accruals until they were actually withdrawn by him. It turned out that, although he reported his income on a cash instead of an accrual basis, the law required him to report the salary credits as they accrued. So that, literally, his return, by failing to report his salary accruals, amounted to a factual, though silent, misrepresentation. In the case at bar, the fact of receipt of the stock was reported, but its value when issued, and not its appreciated value, was entered on the return. Thus, the return did inform the Commissioner of receipt of the stock, whereas the returns in the *Ross* case afforded no information at all with respect to the income in question there.

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*The court said: "Nor probably even when he ought to have known the truth."

It is true, of course, that the value of the Reagan shares at any given time was a question of fact and not of law, but the mistake of law on the part of the taxpayer (Group No. 1 Oil Corporation) lies not in the determination of the actual value of the shares, but in the taxpayer's misconception of its obligation to report and pay tax on that value in 1927.

The taxpayer, as did all the other holders of interests in the 49 per cent of the Reagan stock, believed that as a matter of law the shares were not taxable in 1927, but in 1924 when they had only a nominal value. This is challenged in a footnote to Respondent's brief, where it is said, "The record does not show that the taxpayer contended that the stock constituted income in 1924." (Respondent's Brief 9). That statement fails to give effect to the entire record. The taxpayer's officers, attorneys and agents, who were also the officers, attorneys and agents, respectively, of its affiliates, Group No. 1 Oil Corporation and Texon Oil & Land Company of Texas, filed numerous protests, briefs, claims, and arguments in behalf of those taxpayers, asserting that the stock was received in 1924 and not in 1927.* If, by insulating these affiliated corporations against each other by iron curtains instead of veils, it is found to be literally true that Group No. 2 Oil Corporation, *qua* taxpayer, did not contend that the stock constituted income in 1924, it is nevertheless so just because the Government did not then propose to make an assess-

*Group No. 1's protest (Ex. 1-I R. 137-140), adopted by Texon (Ex. 1-J R. 141-143), Group No. 1's brief supporting claim for refund (Ex. 1-N R. 153-160), adopted by Texon (Ex. 1-M R. 150-152), and the pleadings in the suits filed by Group No. 1 and Texon (Exs. 1-O and 1-P R. 183 and 195) show how consistently it was contended that the Reagan stock was income in 1924 and not in 1927.

ment against the taxpayer. Nor can it be gainsaid that the taxpayer's position with respect to taxability of the stock then was exactly the same as the position of its affiliates, because they all expressed themselves and acted through the same officers, attorneys and agents; and if an assessment had been proposed against the taxpayer, those same officers, agents and attorneys would have made the same contention in the taxpayer's behalf.

If there were no explanatory circumstances disclosed in the record, any one with a fair acquaintance with the practices of corporate taxpayers and the Bureau of Internal Revenue would assume, nevertheless, that with respect to that stock the 1927 return was a mere token or advisory one; that the taxpayer, for some reason, believed that the stock was not legally taxable as income in that year. Its nominal value in 1924 had increased by 1927 to a very large amount, but it still had not been appraised. The entry on the return informed the Commissioner that the stock had been received. There is no record that it had been returned in any prior year.

It could well have been that in 1924 the owners believed that, because of the escrow provided for in the contracts, the stock was not then taxable income and they therefore did not then report it, and that in 1927 they believed that it was returnable in 1924*, and, desiring that the Commissioner be informed of the transaction, they reported the stock on their 1927 returns, but at no value or a nominal value.

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*The earliest record of a positive position assumed by them is the protests of the proposed 1927 assessments, and they there contended the stock was income in 1924. (Group No. 1's protest, Ex. 1-I, R. 137, 138; Texon's Protest, Ex. 1-J, R. 141-143).

The foregoing is not mere speculation. It is to be remembered that the transactions here involved took place some 23 to 25 years ago. Respondent, by his plea of estoppel, has created the necessity for reviewing, and the justification for rationalizing, those ancient events and actions, consideration of which would otherwise have been long since outlawed. The burden is on him to prove the taxpayer had no plausible reason for its action, that it misrepresented the facts and thereby misled the Commissioner. In the absence of any evidence, it is to be assumed that the taxpayer acted honestly and intelligently and in accordance with its understanding of the law.

It may be suggested that if the taxpayers thought in 1927 that the shares should have been taxed in 1924, they could have filed amended returns for 1924. The answer is, there does not appear to have ever been any law providing for amended returns for the purpose of correcting errors in former years, even though the Commissioner in some instances may have permitted the filing of such; and, besides, no tax would have been due for 1924, for the value of the stock still would have been $1.00.

The taxpayer's action in returning the stock for only $1.00 in 1927 was entirely consistent with honesty of purpose. The 49 per cent of the stock had been issued to the taxpayer and its affiliates and Big Lake Oil Company almost three years prior to 1927. It had no value when issued. Although placed in escrow, it could not be recalled by the other party to the contract. It was escrowed only until it could be divided among the owners. As a group they owned it all from the day that Reagan was organized. Even at this late day no one can dispute the fact that

there was then a real and plausible doubt as to whether the Reagan shares constituted taxable income to its recipients in the year 1927 rather than in the year 1924. That question was the subject of three litigations.* In none of the opinions is there a suggestion that the taxpayers did not make the contention in good faith.

But even if the nominal value given to the shares in the 1927 return be looked upon as a misrepresentation of fact, it avails Respondent nothing on his plea of estoppel, because the record teems with evidence of audits and other proceedings by the Government appraising and reporting the value of the stock before the end of the year, 1928, and by the assessment and enforcement of assessments, based on such value, against the taxpayer's affiliates, who received their shares at the same time and under the same contracts and circumstances as taxpayer received its shares.

Even in the meager discussion of the facts in the opinion of the Court of Appeals, that court found it to be true that the Commissioner knew the value of the shares through his investigation of taxpayer's affiliated companies. With that knowledge and the return itself before him, he had all the information he needed. He knew the taxpayer had received the stock and had not returned its correct value.

Respondent seems to attach importance to the finding of the trial court that the Commissioner did not audit the taxpayer because its return reflected a net loss. If he was "scared off" by a reported net loss of only $39,133.97

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*Big Lake Oil Co's case, 34 BTA 1003, 95 Fed. 2d 573 (3 Cir. 1938); Texon Oil & Land Co's case, U. S. Tax Cases Vol. 39-2 p. 10,576 (Dist. Ct.), 115 Fed. 2d 647 (5 Cir. 1940); Group No. 2 Oil Co's Case, R. 183-198 (Settled—not appealed).

on the 1927 return, he was even less self-reliant then than he was in the *Ross* case. A grade school child could have discovered that 544 shares of stock at $244.31 per share would have produced income of $132,904.64, which sum, minus the $1.00 already returned, if added to the return, would have converted the loss into a gain of $93,669.67—a not inconsiderable revenue producing sum, and all the result of recomputing a single item.

But the finding in question is immaterial because it destroys itself. It is that the Commissioner did not examine the return because it showed a loss. He could not have known that the return showed a loss without having examined it. Without having examined it, he could not honestly claim that he had been misled by it; but, for the purposes at hand, knowledge of what it contained is imputed to him whether he examined it or not. It must be assumed that he did examine the return and that he saw the Reagan stock returned at $1.00, while at the same time knowing from his own investigation of the entire transaction and his own appraisal of the shares that the taxpayer's 544 shares were then worth in excess of $132,000. It is the point of MR. JUSTICE FRANKFURTER's decision in the *Ross* case that from that time on the Commissioner was "on his own." In 1928 he knew all, or should have known all.

It is, to say the least, unconvincing for the Respondent to argue that in 1928, when the Commissioner of Internal Revenue was engaged in auditing and checking the records of the transactions and making the demands against the taxpayer's affiliates, the taxpayer did not "officially or pointedly" inform the Commissioner that the same situation

existed with respect to its 1927 income. Surely the taxpayer was under no duty to invite an assessment against itself of a tax which it then in good faith did not believe it owed.

The trial court's finding that the taxpayer did not *"officially and pointedly"* inform the Commissioner in 1927 that it was in the same boat with its affiliates was made, of course, on the theory that the Commissioner is not bound unless he ascertained the facts from the taxpayer, but it goes further than did the court of appeals and inferentially holds that the taxpayer could not absolve himself by telling the Commissioner privately. Nor, says the District Court, in effect, can the Commissioner take a hint. You must make it pointed.

On the plea of estoppel the taxpayer did not have the burden of showing that the Commissioner was fully informed of the facts. Rather, the burden was on the Respondent to show that the Commissioner was not informed from any source. He made no attempt, however, to discharge that burden. The taxpayer, on the other hand, presented indisputable evidence that the Commissioner was fully informed as the result of his audits and examinations of the taxpayer's affiliates, and the trial court found, in short, that the Commissioner knew that the taxpayer had received the stock in question and that it had received it under the same circumstances as the affiliates had received theirs.

Under the facts shown in the record and found by the trial court, it was the Commissioner's duty to make up his

own mind as to the taxability of the taxpayer's income represented by the shares received in 1927.

Conflict with McEachern v. Rose, 302 U. S. 56

In trying to distinguish this case from *McEachern* v. *Rose,* Respondent attaches too much importance to labels of defenses. It is agreed that the defense of recoupment was disallowed in *McEachern* v. *Rose,* but argued that the decision below in this case does not rest upon the right of recoupment (Respondent's Brief 7), but upon what may be conveniently called "quasi estoppel" (Respondent's Brief 6). Possibly that is the same thing that Judge Hutchinson called "want of equity and good conscience" in the Court of Appeal's opinion in *McEachern* v. *Rose.* This Court put no brand on the defense in that suit at all, except to hold that it was not sufficient in view of the statutes which precluded the Government from taking any benefit from a taxpayer's overpayment by crediting it against an unpaid tax whose payment had been barred by limitation.

In *American Light & Traction Company* v. *Harrison,* 142 Fed. 2d 639 (7 Cir. 1944) the Court lumped all such defenses into the same category, saying:

> "In the *McEachern* case, as here, the overassessments for subsequent years resulted from a mistaken treatment of a transaction in an ealier year. There, as here, the barred deficiency for the earlier year exceeded the admitted overpayments for the later years. There, as here, whether it be called recoupment, offset, equitable credit, or some other term, the Govern-

ment's contention was the same, and it is clear that the difference between the defense urged there and that urged here is purely verbal."

Respondent seems to disavow his pleas of estoppel and recoupment lodged in the trial court, and rely now upon some theory of election. It is urged that the court below has simply held, without more, that "since the taxpayer in 1927 reported the Reagan stock as income at the value of $1.00, it may not change its position and use a higher basis for determining gain or loss on the sale of stock in 1941" (Respondent's Brief 7). If this is all, the complete answer is found in MR. JUSTICE FRANKFURTER's decision in the *Ross* case, where he discussed "election" and "quasi estoppel" (169 Fed. 2d, pp. 493-495).

In a further effort to differentiate this case from *McEachern* v. *Rose*, it is said that in the present case no *admitted* overpayment is involved (Respondent's Brief 7). It is difficult to see how it could make any difference whether the overpayment is admitted or not admitted. Any plea that amounts to a plea of estoppel, by whatever name it is called, in answer to a suit for recovery of an overpayment of taxes admits the overpayment, but resists the recovery of it for some underlying reason. Such a plea is by its very nature one of confession and avoidance.

In the case here, the statute fixes the taxpayer's basis for determining gain or loss on the sale of the stock at its value when received in 1927. (Revenue Code, Sections 111 and 112). That basis cannot be changed by any act of the parties. In obedience to the law, the trial court found that the true basis of the 250 shares of stock was $244.31 per

share, or $61,078.68 (Finding 16, R. 38).* Taxpayer sold the 250 shares for $3,750, a net loss of $57,328.68. The Commissioner disallowed the loss, and required the taxpayer to recompute and pay tax as on a gain of $61,078.68 less $1.00. For the year 1941 there has obviously been an overpayment of tax. The claim for refund was made for an overpayment; this suit is for an overpayment; and the answer in effect admitted the overpayment, but said the taxpayer was estopped because it owed unpaid tax on the stock for 1927. Whether or not the Respondent admits liability for the overpayment would appear to be wholly immaterial insofar as differences or similarities between this case and the *McEachern* case are concerned. If the taxpayer ultimately recovers, the judgment will establish the overpayment, and that the Government cannot credit it against a barred 1927 tax liability.

As a part of his "Statement" Respondent has repeated a sentence of the trial court's 19th finding (R. 38) to the effect that the taxpayer failed to establish "that it did not during the calendar year 1941 earn normal and surtax net income in the amount of $54,968.06 and excess profits tax net income in the amount of $60,547.83, as determined by the Commissioner of Internal Revenue." That is an assertion that, even though the taxpayer was right in its contention with respect to the statute of limitation, nevertheless it was possible that the taxpayer had other net earnings in 1941, which, regardless of the stock transaction, justified the assessment of the tax.

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*In paraphrasing the 16th finding of the trial court (Respondent's bf. 5), the Respondent failed to mention the fact that the trial court found as a fact that this was the taxpayer's true basis.

In view of the Commissioner's 90-day letter (R. 253), upon which the assessment was made, and which set forth the taxpayer's income, deductions, and whole liability for that year, that contention and finding is wholly unwarranted. That letter shows that the net adjustment to taxpayer's income in the amount of $61,078.68 was due entirely to the stock transaction [R. 259, subd. (f) and 265, subd. (b)]. There is no presumption that the taxpayer owed the Government on account of any transaction or income that was never mentioned in the 90-day letter or in the assessment made.

Respectfully submitted,

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